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CABINET AFFAIRS STAFFING MEMORANDUM

Date: 2/14/84 **Number:** 168912CA **Due By:**

Subject: Cabinet Council on Economic Affairs - Thursday, February 16, 1984
8:45 a.m. - Roosevelt Room

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
GSA	☐	☐
EPA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
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______	☐	☐
Baker	☑	☐
Deaver	☐	☐
Darman *(For WH Staffing)*	☑	☐
Jenkins	☐	☑
Mc Farlane	☐	☑
Svahn	☑	☐
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CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/	☐	☐
CCHR/Simmons	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/	☐	☐

REMARKS:

The Cabinet Council on Economic Affairs will meet on Thursday, February 16, 1984 at 8:45 a.m. in the Roosevelt Room.

The agenda and background papers are attached.

DCI EXEC REG

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☐ Katherine Anderson
☑ Tom Gibson

☐ Don Clarey
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THE WHITE HOUSE

WASHINGTON

February 14, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the February 16 Meeting

The agenda and papers for the February 16 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider two related agenda items. The first is the report of the Working Group on the Underground Economy. They will present one of the thirteen economic policy studies commissioned by the Council on June 30, 1983. The report reviews the effect of the underground economy on Federal tax revenues and budget outlays, and presents several proposals for reducing the adverse effects of the underground economy.

The second agenda item is on the tax gap. The Internal Revenue Service in coordination with the Office of Tax Analysis has prepared a paper answering the most frequently asked questions about the income tax gap and reviewing the two key Internal Revenue Service programs directed at reducing that part of the income tax gap represented by the unpaid tax on income obtained in the normal economy.

Attachments

THE WHITE HOUSE

WASHINGTON

THE CABINET COUNCIL ON ECONOMIC AFFAIRS

February 16, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Report of the Working Group on the Underground Economy (CM#408)
2. The Income Tax Gap (CM#408)

Economic Policy Study Number 8

Underground Economy

January 25, 1984

Table of Contents

Executive Summary

Analysis

- In the past several years, the press and academic writers have devoted considerable attention to the underground economy. Some have claimed that it is large and rapidly growing, and that failing to account for it substantially distorts economic policy making.

- The concerned Federal agencies responded to the growing attention to the underground economy by initiating research programs to assess it. The results available at this time indicate that it is not nearly so large as had been claimed by some of the writers.

- For 1981, the Internal Revenue Service has estimated that approximately 15 percent of the income tax gap relates to the underground economy.

- The Bureau of Labor Statistics has found no convincing evidence that official economic statistics like unemployment rates or inflation rates are seriously biased by the existence of the underground economy.

- The Bureau of Economic Analysis estimates that the gross national product may be understated by 3 to 4 percent.

- Some excess outlays in entitlements programs probably occur because beneficiaries are able to conceal employment in the underground economy. No systematic studies of the magnitude of the excess have been made.

- There are, in theory, several ways that the existence or growth of the underground economy could affect the performance of the economy as a whole. But the available information concerning the underground economy is not sufficiently precise or detailed to permit empirical assessment in this area.

Policy

- Major policy initiatives which might affect the underground economy, such as thorough simplification of the Internal Revenue Code or elimination of earnings restrictions for social security recipients, should be considered as elements of the Government's law enforcement strategy, tax policies, entitlements outlay control programs, or regulatory policies. No such sweeping changes in policy could be justified by their effects on the underground economy alone.

- The Administration should consider a requirement for individuals to report, with their tax returns, payments to other individuals where the amounts exceed some threshhold amount.

- All entitlement programs with significant potential for fraud due to concealment of income should be identified and systems to measure the extent and detailed nature of fraud should be implemented.

- For those entitlements in which fraud is found to be a significant problem, structural reforms, more extensive use of third-party information, and more vigorous enforcement should be considered.

- The Administration should consider making Community Work Experience Programs mandatory for able-bodied adult beneficiaries of the AFDC and Food Stamps programs.

- The Administration should consider supporting the expansion of the random audit program in the unemployment insurance system.

- The unemployment insurance random audit program should be structured so that reasonably precise estimates of the extent of various types of fraud (including those related to the underground economy) can be made from the results of the audits.

- The Administration should continue its support of the Comprehensive Crime Control Act of 1983 to increase the authority and capability of law enforcement agencies to combat illegal activities in the underground economy.

- The statistical agencies and IRS should continue their research concerning the underground economy; they should coordinate their efforts and share their results in the interests of efficiency.

Chapter I

Definition of the Underground Economy

As a guide in preparing this report, the working group has defined the "underground economy" as economic activity which is not properly reported to the government and which is either itself illegal or is conducted informally to minimize the chances of detection by government authorities. In the first section of this chapter we discuss the classes of activities which have been discussed in the underground economy literature. In the second section, we discuss the working group's definition in more detail.

I. Classes of Activities in the "Underground Economy"

Over the past several years, a number of observers have called attention to a part of the economy which they variously characterize as "subterranean," "underground," "irregular," or "unobserved." These authors have not reached a consensus definition for the term "underground economy." The term has nevertheless entered the popular vocabulary. Generally, this segment of the economy is said to consist of some or all of the following elements:

- activities which generate income which is not reported for income taxation;
- informally organized activities which are not intrinsically unlawful but which frequently violate some non-criminal rule or law, and which may not be recognized in the official estimates of economic activity;
- economic activities in which currency, rather than bank credit, is used as the principal medium of exchange, in order to avoid creating a record of the activities;
- illegal activities, such as narcotics trafficking, prostitution, and some types of gambling.

There is considerable overlap among these elements. There is also some overlap between them and activities which most people would consider to be part of the normal economy. For example, many normal retail businesses conduct substantial portions of their business in currency. Frequently, wages, interest, or dividends paid by ordinary business enterprises are not reported on tax returns by the recipients. It is evident that it is not possible in a few words to define a sharp and meaningful boundary between the "underground economy" and the normal economy.

II. The Working Group's Definition

The working group's definition is somewhat narrower than the implicit definition embodied in the underground economy literature. The following points are intended to clarify our definition and to highlight some ambiguities.

- "Informal" economic activity is not susceptible to precise definition. It generally involves: very limited record keeping; word-of-mouth advertising rather than newspaper, yellow pages, or broadcast advertising; working out of a residence rather than a fixed business location. It frequently involves secondary ("moonlighting") rather than primary employment.

- The definition could be applied to entire enterprises or to particular types of transactions. The more comprehensive transactions interpretation will be used so that, for example, a tow truck operator would be considered part of the underground economy only when he provides cut rates for cash fees that he will not report. If this represents five percent of his business receipts, then that five percent would be counted as part of the underground economy while the remaining 95 percent would be considered part of the normal economy. Similarly, a dentist would be a part of the underground economy to the extent that he accepted, with the intention of failing to report, a barter payment from a patient, even though all his other business was recorded on his books.

- It is possible for a particular activity to appear to be in the underground economy from one agency's perspective and in the normal economy from another agency's perspective. For example, IRS and Treasury are concerned about the tax gap and revenues that could be raised from it with stronger enforcement measures and a more uniform tax law. If a gypsy cab driver has failed to pay for a hack license but has fully reported his earnings on his tax return, Treasury may consider him to be in the normal economy whereas the hack bureau operated by his city government would consider him to be in the underground economy. Further, interest of the Department of Justice may not be raised unless it is discovered that he is an illegal immigrant. Suppose also that he is underreporting his earnings to welfare authorities in order fraudulently to maintain eligibility for state and federal transfer payments. These earnings would be part of the underground economy from the point of view of the Department of Health and Human Services.

- Not all criminal activity is included in the definition. Only criminal economic activities--those in which goods and services are produced or distributed--are included. Income from theft, extortion, arson, etc. is excluded. (Incomes from such activities are technically transfers rather than returns from productive economic activities).

The definition set forth at the beginning of this chapter will be used in the remainder of this report principally to deal with unpaid taxes and excess outlays, which represent the principal federal consequences of the underground economy discussed in this paper.

Chapter II

Factors which Explain Participation in the Underground Economy

While all activities in the underground economy are concealed from the authorities, concealment is not the only motivation for the activities. The small-scale, personal nature of informal arrangements may appeal to many participants in the underground economy because of life style preferences. Furthermore, some individuals may be attracted to activities which are particularly well-suited to informal organization--such as cutting and distribution of firewood, for example. It is possible that these factors would induce substantial numbers of people to participate in the activities and organizational styles of the underground economy even if taxes and other regulations were not burdens. This proposition is supported, for example, by the IRS estimate that 17 percent of the incomes of informal suppliers were in fact reported on income tax returns.

In the following discussion, we describe several factors which may explain participation in the underground economy. (There are no studies which empirically verify these factors or measure their relative importance.) It is likely that these separate factors operate simultaneously in a reinforcing way. For example in cases where employer and employee are both in the underground economy, they may have different motivations. The employee may prefer informal work arrangements in order to obtain fraudulently some kind of public assistance, while the employer may prefer informal operation to avoid paying taxes.

I. Tax Law Factors

While some individuals may be drawn to the underground economy by its casual nature, others are undoubtedly induced to join it by the opportunity its informal structure affords for evasion of taxes imposed by all levels of government. Individuals may be unwilling to comply because of the absolute levels of their liabilities or because those liabilities are perceived to be inequitable in comparison to the actual or perceived payments of others. Individuals may also be unable to comply because of technical inability to complete the required forms or to keep the necessary records.

It is reasonable to hypothesize that the payment of tax is a sufficiently high cost of marginal business transactions that many of them are conducted underground to reduce that cost. (The cost includes not only the actual outlay for income tax and employment tax but also the administrative costs of compliance--record keeping, return filing, etc.) In theory, any reduction in federal, state, or local taxes (or the costs of compliance) would, therefore, work to reduce the size of the underground economy--other things remaining the same. It is difficult, however, to estimate the effect of a reduction in these burdens. The net impact of such reductions on revenues cannot, therefore, be determined.

II. Non-Tax Factors

We consider the factors which explain illegal activities--drug trafficking, gambling, prostitution--to be self-evident and consequently focus attention below on the non-tax factors which may explain why persons select informal modes of legal economic activity. Governments may inadvertenly create incentives to engage in such activity by establishing income or earnings tests for entitlements and by promulgating regulations which restrict economic activities.

Entitlements

Economic assistance of various kinds is available to people if their circumstances meet specified criteria. Generally, there are maximum-income or maximum-assets limits for beneficiaries of these programs. Many programs impose other requirements as well--such as minimum age, responsibility for dependent children, need for medical care, etc. The largest income maintenance program is Old Age and Survivors Insurance--popularly known as social security. The rules for determining benefits are fairly complicated, but generally they involve age, period of prior covered employment, and earned income. If a person meets the prior-employment requirements and is under age 70, but has earnings in excess of the exemption level, the amount of the benefit is reduced by one-half of the excess. Some other assistance programs reduce benefits to zero for otherwise-eligible persons whose earnings or total income exceed prescribed maxima.

The existence of assistance programs obviously creates incentives for dishonest persons to misrepresent their circumstances in order to receive benefits to which they are not entitled. Many observers have likened the incentive to that created by income taxes. In the case of social security recipients below age 70, the relationship between benefits and income exceeding the exemption level can be thought of as a fifty percent "tax" at the margin since total disposable income--benefits plus earnings--increases by only one-half of the increase in earnings. If the earnings would be subject to income tax as well, the combination of the marginal income tax rate and the fifty percent benefit reduction can be thought of as a total marginal "tax rate" on earned income. This situation creates an even stronger inducement for individuals with the required age and prior-employment characteristics to understate their incomes.

To the extent that administrators of assistance programs attempt to verify eligibility for benefits, effective misrepresentation must involve concealment as well as understatement. The informal portion of the underground economy provides an opportunity for concealment. While earnings in informal enterprises may be lower and less predictable than in the normal economy, the absence of record-keeping and reporting to the revenue agencies facilitates fraudulent receipt of benefits as well as tax evasion. The fraudulent beneficiary may be an entrepreneur engaging in informal activity or an employee working "off the books" for a formal or informal business.

Regulations

Federal, State, and local governments impose many requirements on businesses concerning the goods and services they sell or the manufacturing and distribution processes they use. In general, these requirements increase businesses' costs in two ways. First, production or distribution costs are raised in order to meet the requirements. Second, enforcement and monitoring of the regulations usually involves keeping particular kinds of records, filing particular kinds of reports and forms, and other types of administrative burdens.

To the extent that regulations apply to all firms providing a given class of goods or services, the costs associated with regulation can be "passed through" to the purchasers. Profits, therefore, may not be reduced at all or may be reduced by substantially smaller amounts than costs are increased. However, from the point of view of a particular enterprise, avoiding costly regulations can have the effect of increasing profits or of enabling marginal enterprises to remain in business. Effective avoidance may require adoption of the informal business practices of the underground economy.

Federal regulations which, by increasing costs of doing business, may create incentives for enterprises to participate in the underground economy include the following: the minimum-wage and maximum-hours rules imposed by the Fair Labor Standards Act, the occupational health and safety rules, the environmental protection requirements, consumer product safety rules, and possibly others. Some State and local governments impose similar or additional requirements in these areas. Many kinds of activities are also governed by licensing, building codes, public health rules, and other requirements.

Miscellaneous

The foregoing is undoubtedly an incomplete accounting of factors which induce persons to participate in the underground economy. The following additional factors are of particular concern to one or more Federal agencies.

Illegal immigrants may not legally work for pay in the United States. (Under present law, employing illegal aliens is not proscribed.) To avoid detection, illegal aliens may seek informal employment.

Federal patent, copyright, and trademark laws confer private property rights on persons or firms. Other persons or firms can profit by infringing these rights. Informal kinds of businesses may be better able to escape detection by the government or by the owners of the rights.

Chapter III

Effects on Tax Revenues

In this chapter we discuss estimates of the income tax receipts lost due to the existence of the underground economy. However, it is important to note that the estimate of revenue losses due to the underground economy may not correctly measure the expected gain in receipts if opportunities for underground transactions were closed off entirely. This is because some individuals operating in the underground economy would be driven from business by the costs, including taxes, of operating above ground. An estimate of federal tax gain from reducing the size of the underground economy would have to take this effect into account.

IRS compliance research has addressed the underground economy as it pertains to the Federal government's income[1] tax. For tax year 1981, the income tax gap in the U.S. economy is estimated at $92 billion, of which $14 billion is due to the underground economy. (The estimate of the income tax gap attributable to individuals includes unpaid tax on all estimated income earned in the underground economy, even though some part of that income may be received by corporations; the available data do not allow us to estimate how large that part may be.) The tax gap is defined as the difference between the total amount of income tax voluntarily paid for a given tax year and the correct tax liability for that year.

The underground economy accounts for about 15 percent of the income tax gap. The remainder reflects many forms of noncompliance unrelated to the underground economy. For example, individuals who fail to report interest income received from banks add to the tax gap although the income is not in any sense "underground". The following table displays the major elements of the income tax gap, including the portion related to the underground economy. (Details may not add to totals because of rounding.)

[1] Illegal and informal economic activities also tend to erode the Federal tax base by impeding collections of employment taxes and, to some extent, excise taxes. Thus, the total impact of the underground economy on the entire revenue system of the United States has not yet been measured.

				1981 Tax Gap (\$ Billions)
Individuals				84.3
Normal Economy			70.3	
Filers' Unreported Income		47.6		
Filers' Overstated Deductions		12.9		
Under-remittance		7.3		
Nonfilers		2.5		
Underground Economy			**14.0**	
Informal Sector		5.0		
Illegal Sector		9.0		
Heroin, Cocaine and Marijuana	6.1			
Gambling	.9			
Prostitution	1.9			
Corporations				6.2
Total				90.5

The informal sector consists of self-employed moonlighters, vendors with informal business styles and other individuals whose activities are not necessarily in conformity with technical requirements for licensing, permit filing, and performance codes, but whose incomes are otherwise legitimately earned. Such informal suppliers may serve either households or business establishments. So far, IRS compliance research has only estimated tax gaps associated with unreported income of informal suppliers serving households. For tax year 1981, this gap was $5.0 billion.

A provisional estimate of the tax gap associated with the three most important types of illegal-source income amounted to $9.0 billion for 1981. To draw attention to the extraordinary difficulties encountered in estimating tax gap associated with the illegal sector, **a standard error of $3.2 billion was calculated to accompany the $9.0 billion estimate.** It could thus be said with 95 percent confidence that the true tax gap is between $2.6 billion and $15.4 billion. This figure does not include tax gaps associated with theft from households and businesses, frauds against government, and other predatory crimes, which are generally considered to be income transfers rather than economic activities. Adding the $9.0 billion illegal sector tax gap to the $5.0 billion for the informal sector gives a total tax gap point estimate for the underground economy of $14.0 billion.

The illegal- and informal-sector tax gaps are difficult to close. Both the opportunity and the willingness not to comply with the tax laws are particularly high in these areas. The cash payments that frequently predominate frustrate efforts to establish audit trails. In the illegal sector, and frequently in the informal sector, there is no filing of information returns by payers of income. When the payments involved per transaction are small, as they frequently are, it makes it costly to detect them through enforcement action. In the illegal sector, the participants have a strong motive not to reveal their transactions to any government agency. Moreover, a person who is willing to violate non-tax statutes might generally be more willing to violate the tax laws as well.

Chapter IV

Effects on Federal Outlays

Concealed income obtained through activity in the underground economy affects Federal expenditures, principally through the payment of excessive benefits under Federal and Federal/State assistance programs. (Note that we do not consider here the costs of enforcement programs.)

Administrators of assistance programs cannot take account of income or asssets concealed in the underground economy in establishing individuals' eligibility or benefits. The number and size of benefit payments is thus increased by the existence of the underground economy. Because several major benefit programs have income or resource tests, and the total of benefit outlays in these programs is large, it is possible that these outlays are substantially greater than they should be because of underground activities of recipients. (Note, however, that caution must be exercised not to interpret the amount of excess outlays associated with the underground economy as the amount by which outlays could be reduced if the underground economy were to be eliminated. Some persons who are employed in the underground economy and fraudulently receiving benefits would, if compelled to make a choice, choose the benefits and forgo the employment. A similar point was made in the previous chapter concerning revenues.)

It is not presently possible to present estimates of excess outlays in the assistance programs associated with the underground economy. There are two reasons. First, comprehensive measures of fraud in general are not available. Second, there are no measures of the portion of fraud due to participation in the underground economy. On the first point, the Internal Revenue Service has recently concluded an effort to obtain estimates of fraudulent benefits of assistance programs (because fraudulent benefits, unlike most legitimate benefits, are taxable). The conclusions of the IRS consultants--Abt Associates Inc.--on the general problems of measurement are summarized in the next paragraph.

Most of the assistance programs have quality control offices which compile estimates of errors in benefits (payments to ineligible persons or of incorrect amounts). However, the statistics used by these offices do not distinguish administrative errors from fraud on the part of the beneficiaries (unemployment insurance is an exception). Since some errors are not the result of fraud, and since some fraud is undoubtedly not detected in the quality control programs, the error statistics cannot be used to obtain estimates of fraud. Furthermore, reliable fraud statistics, if they existed, might not include a category relevant for the purposes of this paper. A category called, for example, "unreported wage income" would presumably include beneficiaries' failure to report income from work in the normal economy and in the underground economy.

Following is a table showing recipient and benefit levels for the programs dealt with in this paper:

	Fiscal Year 1983 Estimates	
	Recipients (Millions)	Benefits ($ Billions)
Social Security		
Old Age and Survivors Insurance	32.1	148.2
Disability Insurance	3.9	17.5
Black Lung		
SSA Administered	.4	1.1
DOL Administered	.1	.6
Aid to Families with Dependent Children	10.4	12.0
Supplemental Security Income	3.9	7.8
Medicaid	21.8	34.3
Low Income Home Energy Assistance	N/A	1.9
Food Stamps	21.6	11.2
Unemployment Insurance	10.6	27.2
Railroad Retirement Board	1.0	6.5
Subsidized Housing	3.9	10.7
Community Development Grants	N/A	3.5
National School Lunch Program	40.5	2.3
Total		284.8

Abt Associates' analysts were able to estimate fraud for only five of these programs: Aid to Families with Dependent Children, Supplementary Security Income, Medicaid, Food Stamps, and Unemployment Insurance. The estimates ranged from 0.2 percent to 4.5 percent of total benefits. The average--using 1983 benefit weights--is 2.8 percent. There is no reason to suppose that this average fraud rate for five programs would apply to the remaining programs. It is reasonable to suppose, in fact, that the Old Age and Survivors Insurance Program, which accounts for more than half the total entitlements outlays, would have a substantially lower fraud rate because the requirements for eligibility are relatively simple. Given that only part of total fraud relates to the underground economy, it seems clear that the excess outlays arising from the underground economy are much smaller than the lost revenue.

Income/resources tests are built into each of these programs. To varying degrees each program has enforcement measures designed to detect earnings and resources affecting eligibility or benefit amounts. The enforcement measures, however, depend heavily on reports of earnings filed by employers and are not fully effective in detecting underground earnings. The Appendix contains a summary of the provisions of the programs.

Chapter V

Effects on Economic Performance

The underground economy could have two distinct types of effects on the performance of the total economy (the normal economy plus the underground economy). First, the existence or growth of the underground economy could affect the actual levels of production or the pattern of distribution of income or some other aspect of the actual total economy. Second, the underground economy could affect the statistical measures of economic performance, which could influence economic policy and in turn affect the actual economy.

I. Effects on Actual Economic Performance

The possible effects of the underground economy on economic performance depend on many facts which are presently unknown concerning the underground economy. The economists who have published estimates of the size of the underground economy have used particular theories which depend on assumptions which are not universally accepted. But even if there were a consensus concerning the size and rate of growth of the underground economy, still other information would be required to appraise the impact on actual economic performance. For example, it would be necessary to know the relative rates of productivity change in the underground and normal economies. This and other essential items of information are simply unavailable. Accordingly, the following discussion is purely theoretical. Some of the effects discussed could exist but be very small. For others, even the direction of the effects is unknown. In view of the paucity of information concerning the effects of the underground economy on actual economic performance, the working group is persuaded that no changes in economic policy would be justified solely on the ground that they would reduce or eliminate any undesirable effects.

One possible effect of the underground economy on the performance of the total economy is through its impact on the federal budget. As described in the preceding chapters, the underground economy may cause receipts to be lower and outlays to be larger than they would be if the same activities occurred in the normal economy. To the extent that the federal budget affects the level, growth, or fluctuation of economic activity, the underground economy can have effects on actual economic performance. The available estimates of the effects of the underground economy on outlays and receipts are clearly not sufficiently complete to justify any conclusions concerning the magnitude or direction of such effects on the performance of the economy.

The underground economy exists in part because of some individuals' efforts to conceal production and distribution of products or use of production processes (including labor practices) which violate various rules and regulations. A pure laissez faire view would consider that, by circumventing attempted government interference in economic choices, the underground economy increases total welfare. But, to the extent that the regulations avoided in the underground economy would otherwise promote socially desirable objectives, total welfare is reduced by the existence of the underground economy. Since we have little information on the degree to which the underground economy affects compliance with particular regulations, it is impossible to present a compelling analysis of the net impact of this kind of effect.

Finally, the underground economy could affect actual economic growth. It has been hypothesized that the nature of underground activities causes them to have rates of technologic advancement and productivity growth which are substantially different from the average rates in the normal economy. It is clear that such productivity growth differentials could contribute to mis-measurement of economic growth. This is dealt with in the next section. Whether actual economic growth could be affected is somewhat more conjectural. One may construct theoretically consistent scenarios in which rates of economic growth are affected; such scenarios involve alternative combinations of productivity growth differentials and trends of incentives to participate in the underground economy. However, the information required to judge even the direction of this effect is not available.

In summary, the existence of the underground econony could possibly affect the performance of the actual economy in three ways: (1) through its impact on the federal budget; (2) through the evasion of governmental requirements concerning products and processes; and (3) through differential rates of growth in the underground and normal economies. Empirical assessment of these effects is not presently feasible.

II. Effects on Measures of Economic Performance

The underground economy literature postulates that underground economic activity biases official measures of output, inputs, and prices, as well as statistics based on these measures, such as productivity statistics. Before discussing these specific biases in more detail, however, two general points should be made. The first is that in many cases what may be important to policy makers is not so much the existence of a bias *per se* as the increasing or decreasing amount of bias. A constant and longstanding bias in an economic indicator would reflect an unchanging relationship between the underground and normal economies and would be discounted by policy makers whether they were aware of it or not. Changes in the relationship between the underground and normal economies, however, could change the amount of the bias and policy decisions reflecting the previous degree of bias would no longer be appropriate. The second point is that quantitative statements regarding possible biases in official economic measures are more useful than qualitative statements. While it is important that policy makers be aware of the directions in which the numbers they use may be biased, it is preferable that they also have a reasonably precise estimate of the extent to which these numbers may be biased at any given time. Only if the amount of the bias is known can the biased measure be converted to an unbiased figure on which to base economic policy.

Output Measures

The official statistical series which is most often discussed in the underground economy literature is gross national product (GNP). This series is developed by the Bureau of Economic Analysis of the Department of Commerce (BEA). The estimates of bias are more often indirect than direct. In estimating the size of the underground economy, the official GNP figures are usually used as a benchmark for comparison, with the size of the underground economy expressed as a percentage of the official numbers. Estimates of the size of the underground economy are thus implicitly estimates as well of the amounts by which official GNP figures are understated.

In general, there are two approaches which may be followed in attempting to estimate the size of the underground economy. In the microeconomic approach, the various components of the underground economy are estimated separately and the estimate of the total is obtained by summation. In the macroeconomic approach, the estimate of the total is obtained directly from measures having to do with the economy as a whole, and no attempt is made to estimate specific components. Carl Simon and Ann Witte use the microeconomic approach to estimate 1981 underground national income as at least $330 billion, or 11 percent of GNP. Peter Gutmann and Edgar Feige, working separately but using related macroeconomic techniques, estimate the 1981 underground economy to be $420 billion and $790 billion or 14 percent and 27 percent of GNP, respectively. Other writers estimate that the underground economy is much smaller. Vito Tanzi, for example, estimates that the most likely size is between 4 and 6 percent of GNP.

In comparing official figures derived from direct methods with unofficial estimates derived from indirect methods, the underground economy writers generally ascribe the differences solely to presumed defects in the former. It is not impossible that some part of the differences is due to defects in the alternative estimates. Nevertheless, the controversy has resulted in BEA's conducting a review and evaluation of the methods by which the official GNP figures are developed. The review has concentrated on ways in which gaps or omissions in the data employed may cause those estimates to be too small. The current conclusion of that work is that GNP may be understated by 3 to 4 percent. (This conclusion relates to the legal economy only--drugs, gambling, prostitution, and other illegal goods and services are not included.)

Labor Statistics

Another area in which the underground economy literature considers official statistics to be biased is that of employment. It is claimed that the unemployment rate estimates developed by the Bureau of Labor Statistics (BLS) are higher than they should be because people working in the underground economy are not properly counted. Generally, these claims are simply stated in matter-of-fact fashion with little if any explicit argument presented. Gutmann is an exception. He argues first that BLS estimates of the labor force do not include 1.98 million individuals working exclusively in the underground economy, either full-time or part-time. Such an understatement of the labor force by about 2 percent would imply an overstatement in the unemployment rate, since this rate is calculated by dividing the number of unemployed by the number in the labor force. A recent BLS analytical report on these matters points to a number of logical problems and inconsistencies in Gutmann's analysis.

Gutmann also claims that the BLS estimates of unemployment rates are overstated by about half of a percentage point due to a large number of persons employed in the underground economy who, he argues, are counted as unemployed. He feels that persons receiving unemployment compensation while employed in the underground economy would lie about their employment status in the Current Population Survey (CPS) interviews on which the BLS employment statistics are based. BLS analysts note, however, that Gutmann may have misunderstood the CPS interview procedures, and that he presents no actual evidence to support his conjecture. (It is important to emphasize that the official unemployment rate measures are <u>not</u> based on unemployment insurance statistics.)

Price Statistics

The possibility of bias in price level statistics is more complicated, since writers on the underground economy take different positions on the subject, and since one must take care to distinguish statements about price levels from statements about changes in price levels. Simon and Witte and Fiege argue that price levels in the underground economy are lower than in the normal economy. Feige guesses that prices are from 20 to 40 percent lower in the underground economy due to tax evasion considerations.

Speculations as to differences in price levels between different sectors of the economy at any given time do not relate directly, however, to the question of whether the consumer price index (CPI) understates or overstates the rate of inflation. This is because inflation has to do with changes in price levels over time, not differences at any point in time. Feige argues that the combination of supposed lower price levels and supposed greater rates of growth in the underground economy causes the CPI to overstate inflation because it is a fixed-weight index. By recording only the higher prices existing in the normal economy and by ignoring shifts toward the lower-priced underground economy in consumption patterns, CPI price levels would be progressively higher over time than a true average of prices actually paid by consumers. Gutmann, on the other hand, concludes that the existence of an underground economy causes the CPI to understate, rather than overstate, actual inflation. He argues that underground economic activities are concentrated in industries with lower than average productivity growth. Since productivity growth and price level changes tend to be inversely related, this would mean a greater rate of price level increases over time in the underground economy than in the regular economy. With the underground economy supposedly growing relative to the regular economy, the CPI would then understate the true rate of inflation by tracking only price changes in the regular economy. BLS analysts, however, argue that Gutmann's suppositions concerning differential productivity increases are not supported by the facts. They also analyze Feige's arguments thoroughly and conclude that there is "little chance" that the CPI grossly overstates inflation as a result of "the putative growth of the underground economy."

Productivity Measures

Finally, the underground economy literature maintains that the existence of a large and growing underground economy biases downward official measures of productivity and productivity growth. Unfortunately, the literature does not always distinguish between effects on measured levels of productivity (output per unit of labor input) and effects on rates of productivity growth. With reference to the slowdown in U.S. productivity growth observed during the 1970's, Feige alleges without explanation that the underground economy hypothesis accounts for two-thirds of the portion of the drop which Edward Denison called a "mystery". Generally, however, the explicit arguments presented in the literature apply more to presumed underground economy effects on measures of productivity levels, with the contention being that official measures of productivity are understated because the relevant output measures are understated by greater percentages than are the input measures.

In many cases, these statements are simply presented as corollaries to the authors' main hypotheses that the existence of an underground economy means that official GNP output measures are understated. Some arguments, however, take explicit note of underground economy phenomena such as skimming, or keeping some output "off the books," presumably to reduce recorded profits and taxes. In analyzing the arguments that official output measures are understated more than input measures, Barry Molefsky points out that Gutmann's underground economy numbers imply an annual output of more than $100,000 of goods and services per worker in the underground economy, a figure which BLS analysts find "difficult to accept at face value." BLS analysts grant the possibility that "skimming" may reduce productivity measures, but they also point out that official productivity estimates do not exhibit any differential effects between industries in which skimming might be presumed to be more important and those in which it might be presumed to be less important. Given the lack of reliable data on the possible extent of productivity mismeasurement, they conclude that such claims as Feige's in this area "are based on pure speculation."

<u>Summary</u>

In general, the claims of the underground economy literature that official statistics are significantly biased by a large and growing underground economy do not seem to be borne out by the facts. These claims are often made in a fairly casual fashion and at times in imprecise language. Conclusions sometimes seem to reflect speculation and conjecture more than rigorous analysis. While the government agencies responsible for official economic statistics concede that those statistics are not perfect, their systematic analyses of the arguments presented by advocates of the underground economy hypothesis indicate that official economic statistics are not biased nearly to the extent that these advocates claim.

Chapter VI

Policy Implications

There are major policy initiatives which might reduce the size or growth of the underground economy. However, the working group has concluded that such policies should be judged on other grounds than their impacts on the underground economy. For example, it is possible that major simplification of the Internal Revenue Code might reduce participation in the underground economy (although there is no empirical information to support this proposition). This effect, even if it could be precisely predicted, would probably be a minor consideration in comparison to the considerations of equity and revenue which should motivate such a fundamental change in the Federal Government's revenue system. For another example, elimination of earnings restrictions for social security beneficiaries might reduce participation in the underground economy. However, this effect, even if it could be quantified, would be a minor consideration compared to the budgetary and equity issues related to that policy. There are less sweeping initiatives for which underground economy considerations may be relatively important. These will be discussed below under the following headings: revenue measures, outlay control, illegal activities, and quality of economic statistics. In each case, ongoing work and recent developments will also be discussed as appropriate.

Revenue Measures

The tax reduction provisions of the Economic Recovery Tax Act of 1981 (ERTA) should operate to reduce the size of the underground economy from what it otherwise would be. The most important tax reductions affecting the underground economy should be the 23 percent across-the-board marginal tax rate cuts for individuals, the 10 percent deduction for earnings of the second earner on jointly filed tax returns of married couples, and the indexing of the individual income tax rate schedules, beginning in 1985. On the other hand, while ERTA generally reduced all income tax liabilities, its impact on relative liabilities is much more complicated. If willingness to comply is substantially affected by perceptions of equity, the long run effect of ERTA on the underground economy cannot be easily and reliably predicted.

In addition, there has been a growing concern about the uniform application of the federal income tax. In response, there have been a number of recent legislative, regulatory, and administrative initiatives directed toward improving tax compliance. While these compliance measures have not focused on the underground economy per se, it is possible that the opportunities for concealing income in the underground economy will be reduced. The legislated compliance provisions that may have some effect on reducing underground transactions are the following provisions of the Tax Equity and Fiscal Responsiblity Act of 1982:

- A greatly expanded system of information reporting on taxpayer receipts of interest, tips received by employees of the food and beverage industry, refunds of state and local taxes, purchases of property for resale from direct sellers, and sales of capital assets through brokers;

- A requirement that all debt obligations (of the federal government, private issuers, and state and local governments) be issued in registered form;

- Increased penalties, and a system of backup withholding for persons who fail to provide a taxpayer identification number to, or to correct the number on file with, persons required to file information returns;

- Major increases in the level of fines for tax crimes;

- Broadened jeopardy and termination assessment procedures to deal with large amounts of unclaimed cash;

- Increases in the penalty for fraud from 50 percent of the underpayment to include, in addition, half the interest on taxes due on the fraud items; and

- Changes in the interest rate on taxes due by introducing daily compounding and semi-monthly adjustments on the basis of movements in the prime rate.

Under current law, payments made in the course of a trade or business are required to be reported to IRS in a wide variety of circumstances. Individuals not engaging in business, on the other hand, are required to report payments in only a few circumstances. In the case of interest paid to another individual and deducted by the payer, the payer must report the name and address of the payee. But, in most circumstances, individuals' payments to others, even if they are quite large, are not required to be reported. For example, an individual may pay another individual for substantial home, automobile, or appliance repairs and not report the expenditure. If reporting were required in such circumstances, the reports could be used by

IRS to identify persons in the underground economy who underreport their incomes or fail to file required tax returns. The working group recommends:

- that the Administration consider requiring individuals to report payments, whether or not in the course of a trade or business, where the amounts exceed some threshhold value.

  Pro: The filing of such reports should increase voluntary reporting of the income by recipients; the reports could be used by IRS to detect unreported income.

  Con: The requirement would impose additional record keeping and form filing requirements on individuals; individuals would be required to keep track of transactions which are not relevant to the determination of their income tax liabilities.

Outlay Control

An important conclusion of the working group's endeavor is that the Government's knowledge concerning amounts of fraud in income maintenance and other entitlement programs is inadequate. It follows that the details of such fraud--including the proportion due to concealment of income in the underground economy--are also not known with sufficient precision. The working group recommends:

- that all entitlement programs with significant potential for fraud due to concealment of income should be identified, and systems to measure the extent and detailed nature of fraud in these programs should be implemented;

- that for those entitlements in which fraud is found to be a significant problem, approaches to eliminating or reducing the fraud should be explored; this exploration should include structural reforms, more extensive third-party information reporting, and more vigorous enforcement.

Requiring beneficiaries of income maintenance programs to perform public-service work could prevent some people from obtaining benefits while employed in the underground economy. Some persons who otherwise might commit such fraud would be faced with the choice between public service employment and the income maintenance benefits on the one hand, and underground economy employment and the resulting income on the other. The time required for the two kinds of employment would sometimes not permit both to be done. To the extent that such persons chose to remain employed, public outlays would be reduced. This choice would also reduce one of the incentives to work in the underground economy rather than the normal economy. States are presently permitted to impose work requirements for some benefit programs which receive federal financing. The working group recommends:

- that the Administration consider making Community Work Experience Programs mandatory for able-bodied adult beneficiaries of the Food Stamps and Aid to Families with Dependent Children programs.

The random audit division of the unemployment insurance system conducts investigations of claimants. Specifically, states re-interview randomly selected claimants to verify their initial and continued eligibility for payments. This involves extensive checks of past earnings records and work search efforts. While it is not particularly aimed at the underground economy, it has been successful in uncovering many instances of non-entitlement due to income earned in the normal and underground economies. This program is presently operating in fifteen states. It is scheduled to become nationwide in 1984. The Department of Labor is currently seeking authorization from OMB to provide further support and technical assistance for this effort. This program could serve as a prototype for the measurement and enforcement systems needed in other entitlement programs. The working group recommends:

- that the Administration consider supporting the expansion of this program; and

- that the program be structured so that reasonably precise nationwide estimates of various types of fraud can be inferred from the audits.

  Pro: The additional audits could detect a significant amount of unemployment insurance fraud and deter an even larger amount; the data gathered in the audits could be used both to assess the need for and to design structural reforms and administrative initiatives to reduce unemployment insurance fraud.

  Con: The additional audits would require additional resources and would impose additional burdens on unemployment insurance recipients.

<u>Illegal Activities</u>

In October of 1982, President Reagan announced the establishment of twelve regional task forces to combat organized crime and narcotics trafficking. The Department of Justice has made narcotics dealing and organized criminal activities top enforcement and prosecutorial targets. Increased resources have also been devoted to the attempt to stem the flood of illegal immigrants.

Administration legislative initiatives presently before the Congress would increase law enforcement authority and capability to combat illegal activities in the underground economy. The criminal code reforms, including criminal forfeiture provisions, would advance the Administration's attack on organized crime, which controls much of illegal narcotics trafficking, gambling, and prostitution. Immigration reform, including improved border enforcement and sanctions against those who knowingly employ illegal aliens, could also reduce the size and growth of the underground economy. The working group recommends:

- that the Administration continue its support of the Comprehensive Crime Control Act of 1983 to increase the authority and capability of law enforcement agencies to combat illegal activities in the underground economy.

Quality of Economic Statistics

The attention given to the underground economy in the past few years has generated considerable activity in the agencies concerned with economic statistics.

The Internal Revenue Service established a separate research group in 1977 in response to the burgeoning underground economy literature. That group prepared a report which IRS published in 1979. Since that report was issued, IRS has conducted additional research, including an effort to measure the informal sector through a major consumer expenditure survey and an effort to estimate the illegal sector through assembly of available data on crimes. These efforts and others culminated in publication of an additional report in July of 1983. The conclusion of this work is that the underground economy accounts for a substantial loss of revenue but that it is not the principal type of noncompliance with the Internal Revenue Code (see Chapter III). The estimates developed by IRS in this research program have been useful in supporting the Treasury's revenue estimates for a number of compliance provisions of the Tax Equity and Fiscal Responsiblity Act of 1982. The estimates have also been used to design major new tax compliance initiatives which will raise significant amounts of revenue. These initiatives would, as discussed above, also serve to bring some portion of the underground economy to the surface by identifying sources of income not previously visible to traditional enforcement programs.

The Bureau of Economic Analysis (BEA) has responded to the underground economy controversy by undertaking a major review of the data sources and methods underlying the national income and product accounts. A recent report on this work by the Associate Director of BEA, Robert Parker, concludes that the official estimates of GNP may fall 3 to 4 percent short of the correct values. This research program is continuing.

In response to the underground economy controversy, the Bureau of Labor Statistics (BLS) has established a task force to study the effects of the underground economy on the accuracy of price statistics and productivity statistics. The task force's report was issued in August, 1983. It concludes that the underground economy literature does not make a convincing case for serious bias in the BLS estimates, but that "The issues. . . remain important ones that will continue to be monitored as new findings emerge."

While the concerned statistical agencies and IRS have undertaken considerable research in this field, it is clear that there is still a great deal of uncertainty about the size of the underground economy, and even more uncertainty concerning its rate of growth. As noted in Chapter V, this latter uncertainty may be especially important. Accordingly, the working group recommends:

- that the Internal Revenue Service, the Bureau of Economic Analysis, the Bureau of the Census, and the Bureau of Labor Statistics continue their ongoing research concerning the underground economy, placing special emphasis on its rate of growth;

- and that these agencies coordinate their efforts so that the expansion of knowledge concerning the underground economy is maximized.

Appendix

This appendix contains brief descriptions of the Federal and Federal/State transfer programs which have maximum earnings, income, or resources requirements.

Old Age and Survivors Insurance

The OASI program provides income to retired workers, their dependents, and survivors. The program is financed by payroll taxes paid by employers, employees and self-employed individuals. Section 203 of the Social Security Act states that benefit payments will be reduced if the beneficiary has earnings above the social security earnings test exempt amount. In 1984, an individual age 65 or over can earn up to $6,960, while individuals under 65 can earn up to $5,160, before there is a reduction of benefits (the reduction is $1 for each $2 of earnings over these amounts). Above age 70 there is no reduction for earnings.

Disability Insurance

The Social Security Act was amended in 1956 to provide benefits to disabled workers. The DI program protects individuals and families by providing income to insured disabled workers and their dependents. This program is financed by payroll taxes. Section 223 of the Act states that an individual is to be considered disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment. Earnings of more than $300 per month are generally considered to indicate that an individual is not disabled and therefore not entitled to the benefits of this program.

Black Lung

The Federal Coal Mine Health and Safety Act of 1969, as amended, provides benefit payments for coal miners and their dependents based on the miner's total disability or death due to pneumoconiosis. These payments are made from general tax revenues. A miner or his or her dependent may be eligible to receive both black lung and Title II payments if the miner was employed by the coal mine industry and also had paid FICA tax on a sufficient amount of earnings. The rules for reducing benefits on account of earnings are similar to those of OASI.

Aid to Families with Dependent Children

The aid to families with dependent children (AFDC) program makes grants to States for the Federal share of State expenditures for aid to needy families with dependent children. The Omnibus Reconciliation Act of 1981 provides that no family shall be eligible for aid under the AFDC program for any month if the total family income, not including applicable disregards, exceeds 150 percent of the standard of need as established by the

State for a family of the same composition. States are required to obtain wage information about all AFDC applicants and recipients quarterly from internal State agencies administering unemployment insurance payments, if such information is collected. Those states that do not collect wage data must request wage information annually from SSA. Wage data are to be used to determine eligibility for aid and the amounts of the aid.

Supplemental Security Income

The SSI program is a Federal program designed to provide a minimum income level for people who are 65 or older, blind, or disabled. It replaced, beginning in 1974, the various State categorical welfare programs for the aged, the blind, and the disabled, by amendment of the Social Security Act. It is financed by the general funds of the U.S. government and by contributions from State governments. An SSI recipient is allowed to earn $195 in a calendar quarter before benefits are reduced $1 for every $2 earned in excess of that amount. In addition, only individuals with assets of $1,500 or less and couples with $2,250 or less are eligible. SSA is presently negotiating with IRS to obtain reports of non-wage income to identify recipients who are ineligible by reason of excess resources.

Medicaid

Medicaid was established to enable states to furnish medical assistance on behalf of families with dependent children and of aged, blind, or permanently and totally disabled individuals whose income and resources are insufficient to meet the cost of necessary medical services. States are authorized to provide medical assistance to two categories of people: those categorically in need (eligible for federal assistance under the AFDC and SSI programs) and those medically in need. While the categorically needy are subject to income/resource restrictions specified in the basic federal assistance programs, separate income restrictions govern eligibility of the medically needy. In general, states set their own income and resource limitations for the medically needy so long as they do not exceed federal maxima. Medically needy recipients are usually OASI and DI beneficiaries. Enforcement is piggybacked on enforcement of the basic benefit programs.

Low-Income Home Energy Assistance Program

The LIHEAP provides grants to states and Indian tribes to aid low-income households with energy costs through payments to eligible households, energy suppliers, and building operators. The program was established by the 1974 amendments to the Economic Opportunity Act. Funds are distributed to states upon approval of their plans for administration of their LIHEAPs. In 1981, the Omnibus Budget Reconciliation Act defined households eligible for LIHEAPs as those in which one or more individuals are eligible for AFDC or SSI benefits, food stamps, or certain veterans benefits. Also, any household with income equal to or less than the lower living standard income level as applied under AFDC is eligible. Thus, the income restrictions of AFDC, SSI, Food Stamps, etc. apply to this program.

Food Stamps

The food stamp program helps increase the food purchasing power of eligible households by providing food stamp coupons which can be redeemed for food at retail stores. The Omnibus Budget Reconciliation Act of 1981 restricts eligibility to households with gross monthly income at or below 130 percent of the federal poverty level as established by the Office of Management and Budget. The level is adjusted annually. State agencies which administer the program are required to obtain wage information from unemployment compensation agencies or from the Social Security Administration for verifying eligibility and appropriate benefit amounts.

Unemployment Insurance

The Federal government participates in the costs of state benefit payments to unemployed workers. Eligibility criteria are established by individual State laws and vary considerably. Typically, eligibility depends on the reason the claimant left prior employment, the claimant's availability for work, whether the claimant actively seeks work while receiving benefits, and whether the claimant is working while receiving benefits. The last criterion is common to all states. Most of the states conduct matching to identify fraudulent beneficiaries.

Railroad Retirement

The Railroad Retirement program was established in 1935 and amended in 1974 to its present structure. It provides benefit payments for retired and disabled railroad workers and their survivors similar to those provided under OASDI. The OASDI income restrictions generally apply except in the case of disability annuities, in which case earnings in excess of $200 in a month (unless yearly earnings do not exceed $2,400) cause loss of benefits for that month.

Subsidized Housing Programs

Federal programs provide subsidies to low-income families for payment of rent in privately-owned and public housing. Payments are made monthly to local housing authorities by the Department of Housing and Urban Development. These authorities in turn make payments to private landlords on behalf of low-income families and give credit to families living in housing owned by the authorities. There are means tests in the eligibility criteria. Beneficiary families are required to report income, and the authorities are required to verify the reports. A family qualifies for subsidy if its income, adjusted for certain disregarded amounts, is below 50 percent of the median family income for the geographic area.

Community Development Block Grant Program

The Housing and Community Development Act of 1974 authorizes grants to local and State governments to fund local community development programs. The funding is in the form of low-interest loans to families and small businesses for rehabilitation of houses and business structures. To qualify for a loan, a family or firm must meet a means test; in the case of families, income must be less than 80 percent of the median family income for the area. The test applies only at the time of application for the loan. The Federal outlay--in general the lost interest on the remaining principal on the loan--continues whether or not the family's income increases to a level above the cutoff.

National School Lunch Program

The National School Lunch Program and the School Breakfast Program payments to schools are based on the number of meals served to children in three groups (paid, reduced price, and free) determined by the economic status of their families. To qualify for reimbursement, meals must meet certain requirements, recipient children must be correctly classified according to family income, and meals must be accurately categorized according to the applicable reimbursement rates. Eligibility for free meals is restricted to those individuals whose family income is at or below 130 percent of the federal poverty level established by the Office of Management and Budget. Reduced price meals are provided to persons whose family income is at or below 185 percent of the federal poverty level.

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THE INCOME TAX GAP

Internal Revenue Service

January 25, 1984

THE INCOME TAX GAP

What is the Tax Gap?

The tax gap is the difference between the correct tax liability for a year and the amount voluntarily paid for that year. The word "voluntarily" deserves emphasis because some portion of the tax gap is regularly collected by IRS through its various enforcement programs.

How is the Tax Gap Related to the Underground Economy?

It is estimated that for 1981 the unpaid taxes on income obtained in the underground economy represented approximately 15 percent of the tax gap. (See Exhibit 4). The income in the underground economy is derived from illegal activities (e.g., drug trafficking, illegal gambling, and prostitution) and from legal activities conducted informally to minimize detection by government authorities (e.g., sales of goods in "flea markets"). The underground economy paper discusses this subject in some detail.

The remaining 85 percent of the tax gap is represented by the unpaid tax on income obtained in the normal economy. For example, a business establishment that conducts its business in an open and normal manner and that records all of its transactions may, nevertheless, fail to pay all of the income tax due on its net income. The underpayment is part of the tax gap, but the business is <u>not</u> part of the underground economy.

What are the Components of the Tax Gap?

The composition of the tax gap is shown in attached Exhibits 1-3, which are based on an IRS report published last summer. The estimate of the total tax gap for 1981 is $90.5 billion. Of this amount, $81.5 billion relates to legal activities, and $9 billion to illegal activities. In the legal sector (Exhibit 2), the $81.5 billion consists of $75.3 billion, representing the individual income tax gap, and $6.2 billion, representing the corporate income tax gap. By far the largest component of the tax gap, more than $52 billion (Exhibit 3), is represented by individual taxpayers who fail to report their full income.

What Can Be Done About the Tax Gap?

In an effort to reduce the tax gap, various legislative and administrative proposals could be advanced. However, from the perspective of tax administration, there are two key programs which would be capable of achieving additional reductions in the tax gap at very favorable cost/benefit ratios. The two key programs are the Examination Program and the Information Returns Program.

Examination Program

In the Examination Program, the IRS attempts to maximize the use of its resources by selecting for audit the most productive returns. However, the overall Examination Program strategy is to achieve a balanced program of maximizing direct yield while also assuring adequate audit coverage of categories of tax returns where low compliance rates have been experienced.

The Examination Program's yield/cost ratio has increased over the period 1976 to 1984 from 7.5/1 to over 13/1. However, over this same period, the number of tax returns examined has dropped from 2.5 million to under 1.5 million, while the total number of tax returns filed has increased from 113 million to over 128 million. These statistics indicate that in 1984 the IRS will audit less than 1.4% of the tax returns filed, the lowest audit coverage rate in IRS history. This is a condition well-publicized by others and generally known to the public.

In our efforts to reduce the tax gap associated with many of the areas of taxpayer noncompliance, there is simply no reasonably efficient or effective alternative to an increase in examination resources. While recent tax legislation, expanded information reporting and matching, and significant increases in the use of technology are helping IRS make maximum use of enforcement resources to reduce the size of the tax gap, closing a larger percentage of this gap and achieving greater revenue results will depend to a high degree on the level of resources committed to the examination program.

Information Returns Program

The Information Returns Program (IRP) is probably the most efficient and least intrusive means available to the IRS for detecting unreported income. The IRS matches information documents (which report wages, interest, dividends, etc.) received from payers against appropriate tax returns and contacts taxpayers concerning discrepancies. Typically, 50% of the taxpayers contacted in connection with discrepancies remit the full tax due in response to the first letter from the IRS.

Two recent pieces of legislation will significantly enhance the capacity of the IRP process to detect underreporting by taxpayers: The Tax Equity and Fiscal Responsibility Act of 1982 expanded the types of income subject to information reporting (e.g., tips, broker reporting of gross proceeds, government bond interest); the Interest and Dividend Tax Compliance Act of 1983, which requires financial institutions to solicit correct social security numbers directly from taxpayers, will result in more accurate information being reported to the IRS (correct social security numbers enable the IRS to match information documents with tax returns).

Over the next several years, the capacity of the IRS to process information documents will be dramatically enhanced. The IRS has accelerated this capacity through the introduction of sophisticated optical character recognition equipment. In addition, as a result of recent changes in the law, the IRS has required that more information documents be submitted on magnetic tape rather than on paper.

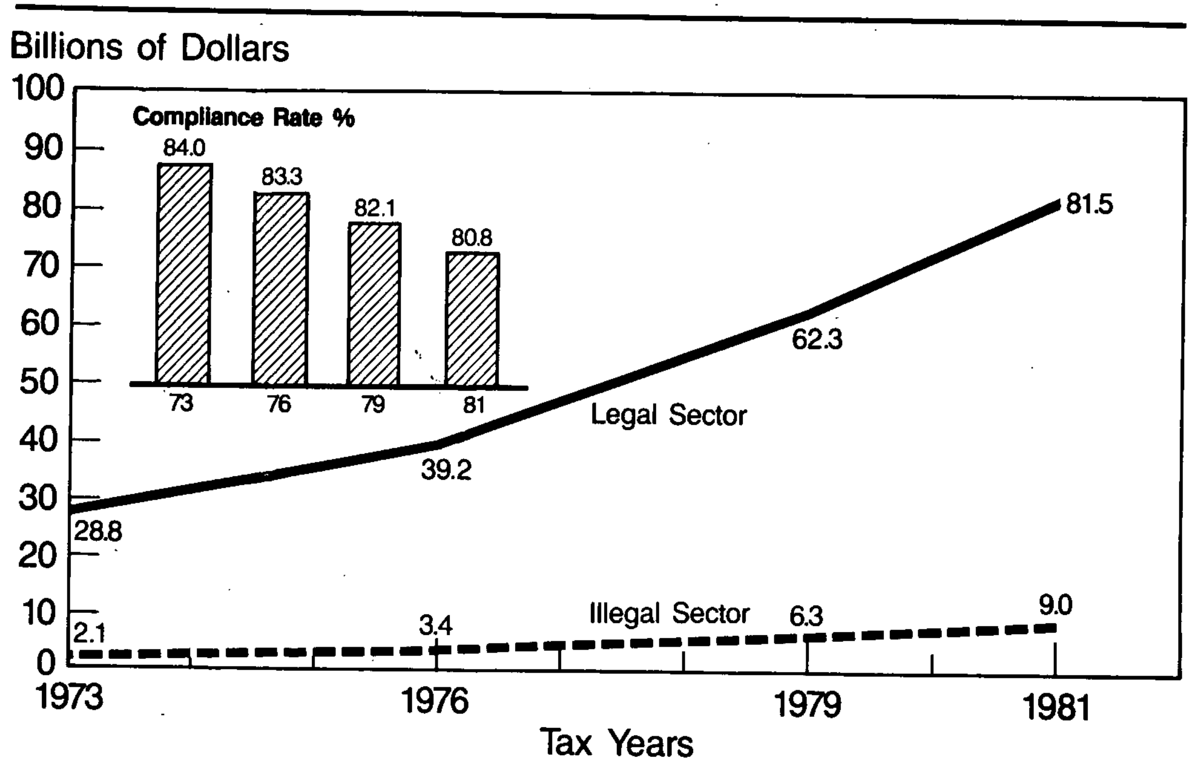
One human function which forseeable technology will not eliminate is the actual screening of discrepancies identified by computer matching of the data on the information documents with the data reported on the tax returns. Although this screening is performed by in-house IRS staff, currently there are employed nothing like the number of individuals necessary to pursue even the existing number of discrepancies, much less the increased number expected in the future.

The Information Returns Program, which is likely to continue as the most efficient tool for detecting unreported income, offers a unique opportunity to achieve meaningful reductions in the tax gap. As in the case of the examination program, achieving greater results in closing the tax gap will depend on the level of resources committed to the Information Returns Program.

Exhibit 1

Income Tax Gap and Compliance Rate, 1973-1981

Legal and Illegal Sectors



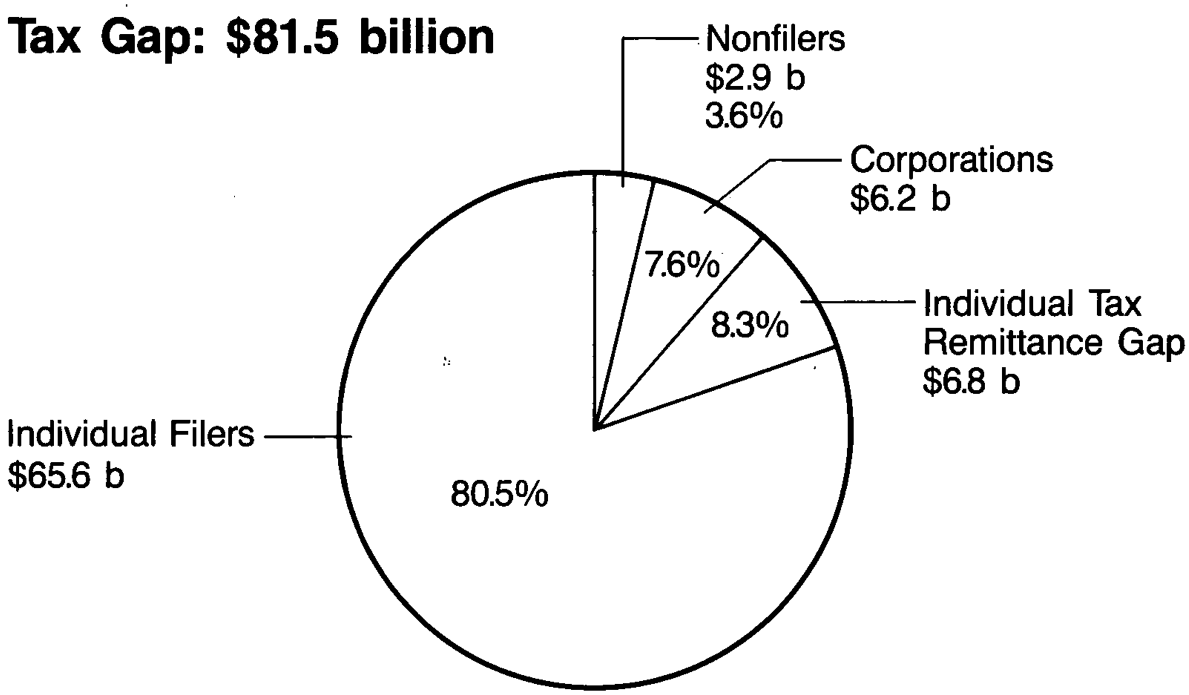
Source: Table I-1

Exhibit 2

Income Tax Gap by Source, Tax Year 1981

Legal Sector Only

Tax Gap: $81.5 billion

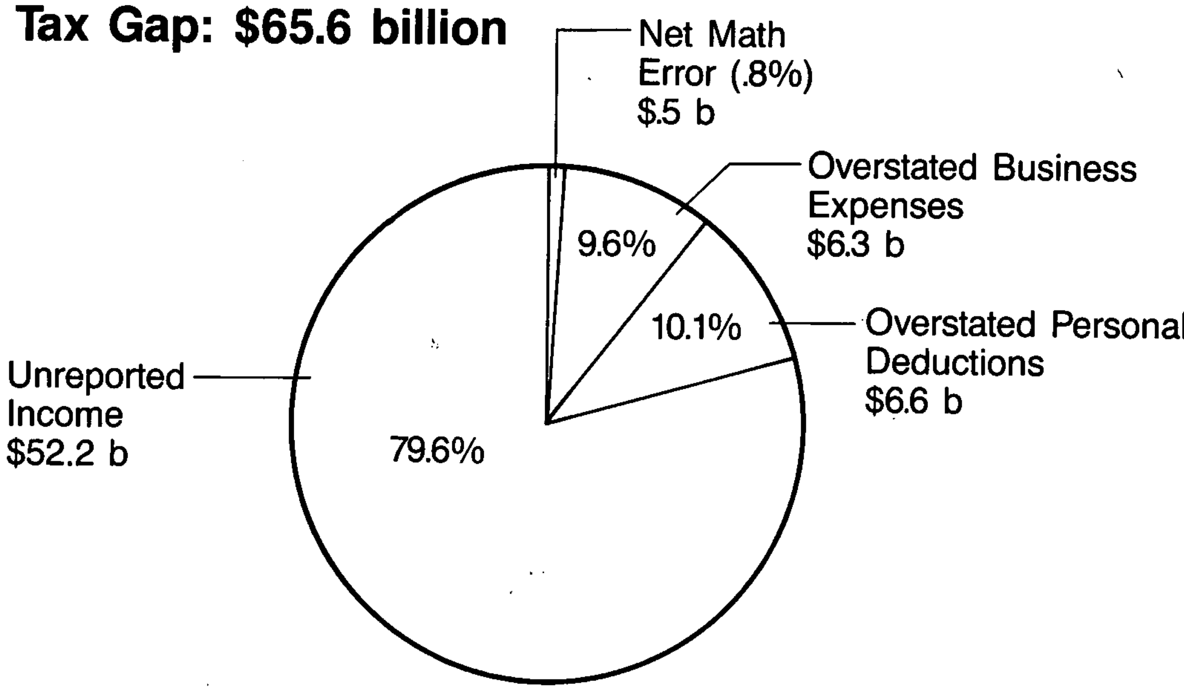


Source: Table I-1

Exhibit 3

Income Tax Gap of Individual Filers by Source, 1981

Tax Gap: $65.6 billion



Source: Table I-1

Exhibit 4

Tax Gap for Normal and Underground Economies

Tax Year 1981 (Billions of Dollars)

	Normal Economy	Underground Economy	Total
Individuals, Legal Sector	70.3	5.0	75.3
Filers' Unreported Income	47.6	4.6	52.2
Filers' Overstated Deductions	12.9	—	12.9
Underremittance	7.3	—	7.3
Nonfilers	2.5	.4	2.9
Individuals, Illegal Sector	—	9.0	9.0
Corporations	6.2	—	6.2
Total	76.5 (85%)	14.0 (15%)	90.5 (100%)